FY 2008 FEDERAL PRISON INDUSTRIES, INC.
ANNUAL REPORT

A Message from the Board of Directors

The Federal Prison Industries' Board of Directors proudly presents the 2008 Fiscal Year Annual Report.

The purpose of the Federal Prison Industries (FPI) program is to provide job skills training and productive work experience that will enable current inmates to find adequate employment when they return to society. This program, launched almost 75 years ago, has achieved significant, measurable success, with a track record of a 24 percent lower recidivism rate among FPI participants.

In FY 2008, there were 21,836 inmates working in the FPI program. With an estimated annual incarceration cost of $30,000 per inmate, FPI's programmatic benefits represent significant taxpayer savings, while restoring former inmates to a useful role in society. An inmate's ability to successfully re-integrate into the community upon release depends upon the opportunities received during incarceration. The FPI program plays a crucial role in creating these opportunities.

Supporting missions include operating in a financially self-sufficient manner, without undue impact on private sector jobs; a requirement of law. Particularly on the last concern, the Board is intent upon striking a balance between preserving employment for law-abiding citizens and finding viable work opportunities for federal inmates. To this end, we continue to explore opportunities in traditional and non-traditional sectors, with private companies that outsource their services beyond our Nation's borders.

We believe that repatriating products currently made outside the United States, for sale to commercial customers, presents a potential growth opportunity for FPI. Working toward such an authority would provide the FPI program new opportunities for increasing inmate employment without negative impact on American workers.

In addition, we are pleased to report that more than 77 percent of FPI's revenue is used to purchase raw materials, supplies, equipment, and services from private sector vendors. In FY 2008, approximately 62 percent of FPI purchases was derived from small businesses, including firms owned by women, minorities, and those who are disadvantaged. This is more than three times the Small Business Administration goal for federal agencies. We are very proud of FPI's efforts in these areas, especially in light of increasingly restrictive changes in federal procurement regulations.

On another important front, FPI has made significant strides to become a "green" enterprise – minimizing negative environmental impact, complying with all applicable regulations concerning safety and health conditions for both inmates and staff, and reducing landfill and hazardous waste generation.

Looking ahead, our vision for FPI supports a commitment to sound environmental leadership. Our expectation is that “green thinking” will become ingrained in our culture, and evident in all we do.

As Board members, we serve from a core belief that we are making a positive impact on people’s lives and on the overall well-being of our society. We take pride in the confidence placed in us. In supporting the program’s multiple missions, we are also aware of the increasing restrictions being placed on FPI. It would be extremely short-sighted to undervalue the importance of FPI’s program relative to other priorities of our Government, even in a time of budgetary constraints.

11/03/08

FY 2008 FEDERAL PRISON INDUSTRIES, INC.
ANNUAL REPORT

DIRECTOR'S MESSAGE

The Power of One Program

It is my pleasure, as Director of the Federal Bureau of Prisons and Chief Executive Officer of Federal Prison Industries, Inc., to join with the Board of Directors in presenting the 2008 Fiscal Year Annual Report.

In most Annual Reports, companies either boast of record-breaking earnings and rising profit margins, or they make amends for poor results and promise better days ahead; they present the "bottom-line." But, FPI is different and, therefore, so is this Report. While revenues and earnings throughout FY 2008 have remained strong, the true measure of FPI's success is reflected in its ability to *change lives.*

Unlike most other government programs, FPI does not rely on taxpayer funding to support its operations. Revenue is generated from the sale of more than 175 diverse products and services to the Federal Government and other business partners. FPI works with Bureau of Prisons, corporate recruiters, educational and community services agencies, and private citizen volunteers to create business opportunities for FPI and employment opportunities for releasing inmates. FPI supports local communities through purchases of raw materials, supplies and equipment to support factory operations.

Ninety-eight percent of all federal inmates are released from prison; some return to a community they have not known for 5, 10, or even 20 or more years. Many of them have difficulty reintegrating into society, and they return to a life of crime.

FPI effectively prevents recidivism by giving inmates meaningful job experience; they learn the importance of a work ethic, being dependable, accepting supervision, getting along with co-workers, and taking pride in a job well-done. And inmates are taught how to search for a job in the community – how to acquire work and keep it. Federal inmates within 18 months of release are offered the opportunity to participate in mock job fairs within their institutions. Recruiters from both Fortune 500 and smaller companies meet with program participants and, through simulated job interviews, help inmates develop effective interview skills.

Guidance is also provided in resume development and the creation of prospective employer documentation folders. Even "dress for success" recommendations are offered to increase inmates' job readiness prospects.

During FY 2008, increased emphasis was placed upon release preparedness and community re-entry. These efforts included working with other law enforcement and government agencies, reaching out to local community resources and faith-based organizations, and engaging inmates and their families to increase the prospects of a successful transition. Bureau of Prisons staff continued their exceptional support to public service, making a difference in the lives of inmates.

As of the end of FY 2008, 21,836 inmates worked in FPI; this represents 17 percent of the eligible inmate population. Our goal is to employ the greatest practicable number of inmates in FPI's industrial and services operations located in federal correctional facilities across the country.

Professional research has demonstrated that inmates who participated in Federal Prison Industries are 24 percent less likely to return to a life of crime following release from prison, and 14 percent more likely to be employed, when compared to similar inmates who did not participate in the program.

The *Power of One Program – FPI* – reaches out to provide our federal inmate population what they need inside prison walls, so that their prospects to become socially well-adjusted, taxpaying citizens on the outside will be more likely. *FPI is a solid investment in all our futures.*

11/03/08

Management's Discussion and Analysis

General

Mission

It is the mission of Federal Prison Industries, Inc. (FPI) to employ and provide job skills training to the greatest practicable number of inmates confined within the Federal Prison System, to contribute to the safety and security of our federal correctional facilities by keeping inmates constructively occupied, to provide inmates with work experience, training and skills, to produce market-priced quality goods for sale to the federal government, to operate in a self-sustaining manner and minimize FPI's impact on private business and labor.

Organizational Structure of Federal Prison Industries, Inc.

FPI is a wholly-owned government corporation created by Congress in 1934. FPI is authorized to operate industries in federal correctional institutions and disciplinary barracks (18 U.S.C. § 4121 to § 4129). The Director of the Federal Bureau of Prisons (BOP), who has jurisdiction over all federal correctional institutions, is the Chief Executive Officer.

In fiscal year 2008, FPI operated in seven business segments: Clothing and Textiles, Electronics, Fleet Management and Vehicular Components, Industrial Products, Office Furniture, Recycling, and Services. FPI has industrial operations at 109 factories located at 76 prison locations that employed 21,836 inmates representing approximately 17% of the total number of inmates housed in BOP facilities as of September 30, 2008. Factories are operated by FPI supervisors and managers, who train and oversee the work of inmates. The factories utilize raw material and component parts purchased from the private sector to produce finished goods. Orders for goods and services are obtained through marketing and sales efforts managed by FPI staff. Services are provided on a non-mandatory, preferred source basis.

FPI processes all customer orders through a centralized customer service center at the Lexington, Kentucky facility. In addition, FPI performs product development, testing and costing at its facility in Englewood, Colorado.

Financial Structure

FPI operates as a revolving fund and does not receive an annual appropriation. The majority of revenues are derived from the sale of products and services to other federal departments, agencies, and bureaus. Operating expenses such as the cost of raw materials and supplies, inmate wages, staff salaries, and capital expenditures are applied against these revenues resulting in operating income or loss, which is reapplied toward operating costs for future production. In this regard, FPI makes capital investments in buildings and improvements, machinery, and equipment as necessary in the conduct of its industrial operation.

While FPI does business with the majority of federal departments, agencies and bureaus, FPI's largest federal government customers include the Department of Defense (DOD), the Department of Homeland Security (DHS), the Department of Justice (DOJ), the General Services Administration (GSA), and the Social Security Administration (SSA).

Critical Accounting Policies

The following discussion and analysis of FPI's financial condition, results of operations, liquidity and capital resources are based upon FPI's financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles. These generally accepted accounting principles require FPI management to make estimates and judgments that affect the reported amount of assets, liabilities, revenues and expenses. In this regard, FPI management evaluates the estimates on an on-going basis, including those related to product returns, bad debt, inventories, long-lived assets, and contingencies and litigation. FPI bases its estimates upon historical experience and various other assumptions that FPI believes are reasonable under the circumstances. The actual results may differ from these estimates when assumptions or conditions change.

FPI believes that some of its accounting policies involve complex or higher degrees of judgment than its other accounting policies. The following accounting policies have been identified by FPI management as being critical and therefore require more significant estimates or reliance on a higher degree of judgment on the part of FPI management.

Revenue recognition: Revenue is generally recognized when 1) delivery has occurred or services have been rendered, 2) persuasive evidence of an arrangement exists, 3) there is a fixed or determinable price, and 4) collectability is reasonably assured. Revenue from contracts that specify a customer acceptance criteria is not recognized until either customer acceptance is obtained or upon completion of the contract. Provisions for anticipated contract losses and sales returns are recognized at the time that they become evident.

Revenue is recognized on multiple element (numerous stages of product delivery, set up, and installation) agreements for manufactured items when the product has been accepted by the customer. Revenue for services provided on behalf of FPI is recognized when the service provider presents a valid invoice including a customer acceptance or completion notice.

Allowance for doubtful accounts receivable: The allowance for doubtful accounts is based upon several factors including payment trends, historical write off experience, credit quality for non-governmental accounts and specific analysis of collectability of an account. During the course of time, these factors may change which will cause the allowance level to adjust accordingly.

When a customer account is determined to be unlikely to be paid, a charge is recorded to bad debt expense in the income statement and the allowance account is increased. When it becomes certain that the account will not be paid, the receivable is written off by removing the balance from accounts receivable and recording an entry to bad debt expense.

As of September 30, 2008 and September 30, 2007, FPI had established an allowance for bad debt in the amount of $.99 million and $1.29 million on accounts receivable balances of $45.86 million and $69.55 million, respectively.

Inventory Valuation: FPI maintains its inventory primarily for the manufacture of goods for sale to its customers. FPI's inventory is composed of three categories: Raw Materials, Work in Process, and Finished Goods. These categories are generally defined by FPI as follows: Raw Materials consist of materials that have been acquired and are available for the production cycle, Work in Process is composed of materials that have moved into the production process and have some measurable amount of labor and overhead added by FPI, Finished Goods are materials with FPI added labor and overhead that have completed the production cycle and are awaiting sale to customers.

Raw material inventory value is based upon moving average cost. Inventories are valued at the lower of average cost or market value (LCM) and include materials, labor and manufacturing overhead. Market value is calculated on the basis of the contractual or anticipated selling price, less allowance for administrative expenses. FPI values its finished goods and sub-assembly items at a standard cost that is periodically adjusted to approximate actual cost. FPI has established inventory allowances to account for LCM adjustments and excess and/or obsolete items that may not be utilized in future periods. This valuation method approximates historical cost.

Program Values

FPI's mission is to employ and provide job skills training to the greatest practicable number of inmates in BOP facilities necessary to ensure the safe and secure operation of such institutions, and in doing so, to produce market priced, quality goods in a self-sustaining manner that minimizes the potential impact on private business and labor.

The goal of FPI is to reduce undesirable inmate idleness by providing a full-time work program for inmate populations (goal of approximately 25 percent of "work eligible" inmates). Many of the inmates do not have marketable skills. FPI provides a program of constructive industrial work and services wherein job skills can be developed and work habits acquired.

As with most governmental programs, the real value of the entity is not readily measured in dollars and cents and is not always contained in the financial reports. FPI has existed as an effective correctional program for 74 years. In the course of the years, FPI has positively impacted the lives of countless inmates and staff members that reside and work in the Bureau of Prisons and the surrounding local communities in which we live.

It is impossible to quantify the extent to which FPI's success has prevented inmate unrest that would have been costly in lives as well as dollars. In the face of an escalating inmate population and an increasing percentage of inmates with histories of violence, FPI's programs have helped ease tension and avert volatile situations, thereby protecting lives and federal property. Prisons without meaningful activities for inmates are dangerous prisons, and dangerous prisons are expensive prisons. The work and education programs of FPI have played an essential role in protecting lives, preserving stability and saving money in America's federal prisons.

At the same time, FPI has met its other goal of offering opportunities for inmates who want to take the personal responsibility for rehabilitating themselves. Most inmates eventually will be returned to society; industrial and educational programs can help them to steer clear of criminal activity after release. FPI plays a vital role in management of inmates, and also improves the likelihood that inmates will remain crime-free upon their release from BOP custody. A comprehensive study conducted by the BOP demonstrated that FPI provides inmates with an opportunity to develop work ethics and skills, contributes substantially to lower recidivism and increases job-related success of inmates upon release.

This study, recognized as one of the most comprehensive studies on recidivism, indicates that inmates involved in FPI work programs and educational programs are substantially less likely to return to prison. The impact on the lives of people who live in the communities in which these inmates will return is immeasurable. Countless lives are spared the devastating impact of continued criminal activity.

Since coming into existence in the 1930s, FPI has been a reliable defense supplier, especially in times of surge demands. FPI has received a number of awards for its outstanding performance as a supplier to the DOD.

Analysis of Financial Statements

Cash and Investments

Total Cash (cash and investments) decreased by $44 million during fiscal year 2008. Primarily four factors, a decrease in accounts receivable of $23 million, an increase in inventory of $69 million, an increase in liabilities of $6.5 million and an investment in PP&E of $12 million, contributed to this change. Cash advances on hand decreased by $63 million, however a significant portion of this decrease is invested in vehicle inventory in support of the Fleet Management and Vehicular Components (FMVC) business segments ongoing production efforts.

Accounts Receivable

The Accounts Receivable balance decreased by $23 million (34%) during fiscal year 2008. Despite record annual sales revenue during fiscal year 2008, Accounts receivable levels reached its second lowest level during this decade. The decrease in Accounts Receivable is due in part to improved communications with the DOD payment offices, and increased utilization of the Intergovernmental Payment and Collection (IPAC) system for DOD collections. The Centralized Accounts Receivable group made several trips to payment offices, streamlined processes and resolved bottle necks. The days to collect ratio dropped from 27 days to collect to less than 19.

Inventory

Inventory increased $69 million dollars (38%) in fiscal year 2008, primarily as a result of a significant increase in orders for retrofitted vehicles from the DHS. The current inventory of $128 million (an increase of $68 million compared to 2007) in the FMVC Business segment is in support of production for the first quarter of fiscal year 2009. The Electronics Business segment reduced inventories by $10 million during 2008 as a result of decreased demand while the Office Furniture segment increased inventory due to a late year increase in backlog for orders to be produced in fiscal year 2009.

Other Assets

In fiscal year 2008, other assets increased by $6.6 million in comparison to fiscal year 2007. During 2008, FPI established a pilot program to produce solar panels in anticipation of an expanding federal market as a result of Executive Order 13423 Strengthening Federal Environmental, Energy, and Transportation Management, which requires federal agencies to improve energy efficiencies by the year 2015. Customarily, suppliers of the raw materials to produce solar panels require advances to procure their own materials. In fiscal year 2008, FPI advanced $6.8 million dollars to raw material suppliers in furtherance of the solar panel initiative.

Liabilities

Total Liabilities increased by $6.5 million during fiscal year 2008. Deferred revenue, used primarily for purchase of vehicles for the DHS retrofit orders, increased by $22.1 million while notes payable decreased as a result of the repayment of the $20 million note payable to the U.S. Treasury. The accrued expense balance as of September 30, 2008 was $3.6 million (38%) higher than that of September 30, 2007 balances primarily due to timing differences in collection of intra-department agreements for services and an increase in utilities expense payable as a result of higher fuel costs. Due to an increase in fiscal year 2008 costs, Federal Employees Compensation Act (FECA) actuarial liabilities increased by $1.5 million (14.8%). Accounts payable remained fairly stable with only a 3.3% decrease for the year.

Revenue and Cost of Revenue

While revenues remained stable during fiscal year 2008, the source of the revenues shifted between business segments. In comparison to fiscal year 2007, fiscal year 2008 sales revenue for the Electronics business segment decreased $107 million while it increased $73 million for the FMVC business segment and $14 million for the Office Furniture segment. The reduction in sales volume for Electronics resulted primarily from the decline in the DOD surge demand for the war and a decline in Single Channel Ground Airborne Radio System orders. FMVC's retrofit line continues to increase as a result of an increase in orders from the DHS while Office Furniture experienced increased volume in orders for seating and case goods. The substantial fiscal year 2007 sales volume for the Electronics business segment allowed the segment to operate well above their break even point. While still profitable in fiscal year 2008, the reduced sales volume for the Electronics business segment resulted in a decrease in net earnings of $48 million in comparison to fiscal year 2007. While significant increases in sales revenue occurred in the FMVC and Office Furniture segments, the lower profit margins for these segments was not enough to offset the lost earnings by the Electronics segment. As a result, gross profit decreased by $36 million (36%) during fiscal year 2008.

Business Segments

In fiscal year 2008, FPI's businesses were organized, managed and internally reported as seven operating segments based on products and services. These segments are Clothing and Textiles; Electronics; Fleet Management and Vehicular; Industrial Products; Office Furniture; Recycling; and Services. FPI is not dependent on any single product as a primary revenue source; however, it is dependent on the federal government market for the sale of its products. FPI's net industrial income (earnings) at the Business Segment level consist of sales offset by cost of goods sold and under /over applied overhead. FPI's net sales and earnings for the fiscal years ended September 30, 2008 and 2007 for each of its current business segments is presented for comparative purposes:

Business Segment	Fiscal Year	
Clothing and Textiles	**2008**	**2007**
Sales	$203,644	$175,271
Earnings	$21,500	$24,296
Electronics		
Sales	$218,848	$326,329
Earnings	$29,683	$77,826
Fleet Management and Vehicular Components		
Sales	$229,168	$156,364
Earnings	$12,761	$1,940
Industrial Products		
Sales	$26,921	$32,804
Earnings	($5,277)	($7,173)
Office Furniture		
Sales	$129,572	$115,993
Earnings	$2,434	($2,465)
Recycling		
Sales	$10,505	$11,183
Earnings	$829	$1,648
Services		
Sales	$35,621	$34,780
Earnings	($1,583)	$714
Corporate Total		
Sales	$854,279	$852,724
Earnings	$60,347	$96,787

Liquidity and Capital Resources

During fiscal year 2008, FPI's net income contributed $3.1 million to its cash position, compared to $45.8 million in fiscal year 2007. However, FPI's cash position remains strong as a result of the last several years of DOD and DHS demand. While DOD demand has diminished, it is still providing adequate revenue and earnings and the DHS demand for retrofitted vehicles is expected to remain strong. In addition, orders for furniture products are projected to increase 27% in fiscal year 2009. Therefore, FPI remains confident that it will continue to maintain adequate cash reserves as well as continue to operate as a self sufficient entity.

Possible Future Effects of Existing Events and Conditions

FPI's Recycling Business Segment is involved in the disassembly of components that may contain heavy metals. FPI management is committed to operating its recycling program in a manner that is safe and fully compliant with all applicable laws and regulations. Toward this end, FPI has established standard operating procedures, sought input from regulatory agencies such as the Occupational Safety and Health Administration (OSHA) and Environmental Protection Agency (EPA), and contracted for testing, inspection and technical advice with private companies with appropriate expertise.

The Office of the Inspector General (OIG) continues its on-going health and safety investigation of FPI's recycling of electronics equipment. As part of this investigation, the OIG is collaborating with a team of occupational health and safety experts from various Federal agencies, including the Federal Occupational Health Service (FOH), the Occupational Safety and Health Administration (OSHA), and the National Institute of Occupational Safety and Health (NIOSH). This team visited the FPI recycling plants and collected data to review its compliance with health and safety regulations applicable to electronics recycling and to ensure that FPI adequately protected staff and inmates from hazards in their work environments. The FOH team provided recommendations concerning FPI's Elkton facility, and FPI is implementing these measures for this operation as well as others based on recommendations received for the other operations. In addition, the Recycling Business Segment is updating its Standard Operating Procedures based on these recommendations.

FPI does not receive appropriated funding for operations and must maintain itself through the results of operations. Historically, FPI operates on a very low margin. The margins are much lower than those of non-governmental corporations of similar size and longevity. FPI has sustained itself on the thin margins despite funding activation of new factories to meet the inmate employment demand caused by the unprecedented growth in the number of inmates in the BOP. The growth demands of the BOP are expected to continue for the foreseeable future.

FPI continues to meet its mission challenges of maintaining a 'self-sufficient' fiscal position; providing adequate inmate employment levels for the BOP's unprecedented growth; and maintaining an aggressive cost containment practice. The corporation continues to balance its self sufficiency as well as the inmate growth in the work force. The financial condition has improved and the corporation's cash reserves are adequate to meet the forecasted needs of the Agency.

The fiscal condition of FPI is currently being driven by support for the war effort. We are optimistic about future growth in the program, however, as the war demand subsides, FPI will return to a fiscal position that is tentative and can be easily impacted by regulating authorities. We anticipate that FPI will continue to sustain itself during post war times.

KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report on Financial Statements

Inspector General
U.S. Department of Justice

Board of Directors
Federal Prison Industries, Inc.
U.S. Department of Justice

We have audited the accompanying balance sheets of the U.S. Department of Justice Federal Prison Industries, Inc. (FPI) as of September 30, 2008, and 2007, and the related statements of operations and cumulative results of operations, and cash flows (hereinafter referred to as "financial statements") for the years then ended. These financial statements are the responsibility of the FPI's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the FPI's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the FPI as of September 30, 2008, and 2007, and the results of its operations and cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

The information in the *Management's Discussion and Analysis* is not a required part of the financial statements, but is supplementary information required by U.S. generally accepted accounting principles. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of this information. However, we did not audit this information and, accordingly, we express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our reports dated November 8, 2008, on our consideration of the FPI's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and other matters. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in assessing the results of our audits.

KPMG LLP

November 8, 2008

KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report on Compliance and Other Matters

Inspector General
U.S. Department of Justice

Board of Directors
Federal Prison Industries, Inc.
U.S. Department of Justice

We have audited the balance sheets of the U.S. Department of Justice Federal Prison Industries, Inc. (FPI) as of September 30, 2008 and 2007, and the related statements of operations and cumulative results of operations, and cash flows (hereinafter referred to as "financial statements") for the years then ended, and have issued our report thereon dated November 8, 2008.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of the FPI is responsible for complying with laws, regulations, and contracts applicable to the FPI. As part of obtaining reasonable assurance about whether the FPI's fiscal year 2008 financial statements are free of material misstatement, we performed tests of the FPI's compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of the financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 07-04, including the provisions referred to in Section 803(a) of the *Federal Financial Management Improvement Act of 1996* (FFMIA). We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, and contracts applicable to the FPI. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion.

The results of our tests of compliance described in the preceding paragraph of this report, exclusive of those referred to in FFMIA, disclosed no instances of noncompliance or other matters that are required to be reported herein under *Government Auditing Standards* or OMB Bulletin No. 07-04.

The results of our tests of FFMIA disclosed no instances in which the FPI's financial management systems did not substantially comply with the (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and (3) the United States Government Standard General Ledger at the transaction level.

This report is intended solely for the information and use of the FPI's management, the U.S. Department of Justice Office of the Inspector General, OMB, the U.S. Government Accountability Office, and the U.S. Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

November 8, 2008

KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report on Internal Control Over Financial Reporting

Inspector General
U.S. Department of Justice

Board of Directors
Federal Prison Industries, Inc.
U.S. Department of Justice

We have audited the balance sheets of the U.S. Department of Justice Federal Prison Industries, Inc. (FPI) as of September 30, 2008 and 2007, and the related statements of operations and cumulative results of operations, and cash flows (hereinafter referred to as "financial statements") for the years then ended, and have issued our report thereon dated November 8, 2008.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of the FPI is responsible for establishing and maintaining effective internal control. In planning and performing our fiscal year 2008 audit, we considered the FPI's internal control over financial reporting by obtaining an understanding of the FPI's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements. To achieve this purpose, we did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*. The objective of our audit was not to express an opinion on the effectiveness of the FPI's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the FPI's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in the internal control over financial reporting that might be significant deficiencies or material weaknesses.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the FPI's ability to initiate, authorize, record, process, or report financial data reliably in accordance with U.S. generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the FPI's financial statements that is more than inconsequential will not be prevented or detected by the FPI's internal control. A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the FPI's internal control.

In our fiscal year 2008 audit, we consider the deficiency, described in Exhibit I to be a significant deficiency in internal control over financial reporting. However, we do not believe that the significant deficiency described in Exhibit I is a material weaknesses. Exhibit II presents the status of prior years' recommendations.

The FPI's responses to the findings identified in our audit are presented in Exhibit I. We did not audit the FPI's responses and, accordingly, we express no opinion on them.

This report is intended solely for the information and use of the FPI's management, the U.S. Department of Justice Office of the Inspector General, OMB, the U.S. Government Accountability Office, and the U.S. Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

November 8, 2008

Improvements are Needed in FPI's Financial Management Systems' General Controls

During the fiscal year 2008 financial statement audit, we evaluated the general control environment and selected application controls. General controls are the structure, policies, and procedures that apply to the FPI's overall computer operations. Application controls are the structure, policies, and procedures that apply to the FPI's separate application systems. The evaluation was performed using the U.S. Government Accountability Office's (GAO) *Federal Information System Controls Audit Manual* (FISCAM); National Institute of Standards and Technology (NIST), Special Publication (SP) 800-53, *Recommended Security Controls for Federal Information Systems*; and as established by OMB Circular A-130, *Management of Federal Information Resources*.

We noted weaknesses in the following FISCAM and SAP general control areas: Access Controls, Segregation of Duties, and System Software.

Access Controls Need Improvement

Network management oversight needs improvement

FPI's Management Information Systems Branch (MISB), performed inadequate oversight in the area of network management related to the general support system and the SAP Millennium system. High risk vulnerabilities were identified in the environment that could compromise the FPI Network. Specifically, network configuration management files, including firewall, router, and switch configurations, were improperly stored on a FPI workstation; file transfer protocol (FTP) was being utilized in an anonymous state; and port security was intentionally disabled without proper authorization.

Department of Justice (DOJ) Information Technology Security (ITS) Standard – Access Control (AC) Control Family, Version 2.1, March 2007, AC-03, "*Access Enforcement*", AC-03.12-01 states: "Controls are implemented to restrict a privileged user's system access to specific terminals when the need for such protection is identified in a risk analysis."

AC-03.10-01 also states: "User privileges for accounts that have access to information security functions operate as documented in accordance with authorization requirements."

DOJ ITS Standard – Configuration Management (CM) Control Family, Version 1.0, December 2006, CM, "*Least Functionality*" CM-07.01-01 states: "Prohibited or restricted functions, ports, protocols, and/or service are disabled or deactivated."

DOJ ITS Standard – Identification and Authentication (IA) Control Family, Version 2.0, December 2006, IA-03, "*Device Identification and Authentication*", IA-03.01-01 states: "The system identifies and authenticates devices before allowing them to establish network connections."

IA-05, "*Authenticator Management*", IA-05.02-51 states: "The password policies require that all passwords be at least eight characters in length."

Finally, IA-05.02-52 states: "The password policies require that the passwords be composed of representatives of at least three of the following character sets: upper case characters, lower case letters, numeric characters, and special characters (for example: ~ ! @ # $ % ^ & * () _ + = - ' [ ] / ? > <)."

Inadequate management oversight of network devices and IT personnel increases the risk of unauthorized users accessing the configurations files; compromising the financial data; bypassing access controls without detection; and potentially affecting the availability, integrity, and confidentiality of the information passing through the network.

We recommend that the FPI:

1. Develop policies and procedures to govern the control of network configuration files, copying of network configuration files using secure copy application FTP, and the management of port security. *(New)*

Management Response:

FPI concurs with the recommendation.

2. Perform and document monthly audits to ensure the implementation of the newly developed policies and procedures. *(New)*

Management Response:

FPI concurs with the recommendation.

Weaknesses in management oversight of access control to the SAP Millennium system

FPI's management performed inadequate oversight in the area of access control related to the SAP Millennium system. We identified the following three weaknesses:

- Access to maintain privileged SAP accounts was not restricted from the Enterprise Resource Planning (ERP) Team. Twelve of 18 active non-system administrator ERP Team accounts were identified with the ability to maintain and control the standard default system administrator SAP accounts, which contradicts proper segregation of duties (SOD) protocol. We were informed that all of the accounts were granted the excessive privilege to maintain and control the standard default system administrator when their accounts were created. We confirmed the Authorization, Audit, Licensing, and Compliance (AALC) group subsequently removed the 12 ERP Team accounts from having privileged abilities.
- Two test accounts within the production environment were not configured to expire within the 30 day allowable period as defined in the SAP system security plan. We confirmed with the AALC group that the SAP roles applied to both test accounts were removed and the accounts were not used.
- A SAP required background job operated under a user identification (ID) account rather than a background job ID account. During the system upgrade from version 4.6 to 6.0, management did not specify that the background job would appear in the log as a user ID account.

Additionally, we noted that the background job was not changed from operating under a user ID account to the background job ID account until it was brought to management's attention. We confirmed the background job was changed from running under a user ID account to a background job ID account.

DOJ ITS Standard – Access Control (AC) Control Family, Version 2.1, March 2007, AC-05, "*Separation of Duties*", AC-05.01-01 states: "The information system enforces separation of duties through assigned access authorization."

AC-05.03-01 also states: "No user has access authorizations or privileges that may allow the user to perform multiple security functions for which the duties should be performed by separate people."

DOJ ITS Standard, AC-06, "*Least Privilege*", AC-06.01-01 also states: "The organization assigns the most restrictive set of rights/privileges or accesses needed by users for the performance of specified tasks."

DOJ Bureau of Prisons, System Security Plan for Millennium; dated 3/21/2008, *Account Management*, AC-02 states: "That appropriate information system account management functions are automated, are being employed in accordance with their operating instructions, and are functioning as intended. That temporary and emergency accounts are automatically terminated after 30 days, if such accounts are authorized."

Without proper management oversight in place over access to the SAP Millennium system weaknesses within audit logs and account management can take place.

We recommend that the FPI:

3. Reassess the roles and responsibilities of the Authorization, Audit, Licensing, and Compliance (AALC) group; adjust and communicate as appropriate. In addition, the communication should also emphasize the importance of following the approved procedures that have been instituted by the FPI Chief Information Officer. *(New)*

Management Response:

FPI concurs with the recommendation.

Unauthorized use of a terminated user's network account

Unauthorized use of a terminated user's account was identified. A terminated user's account was not locked, disabled or deleted within 90 days of inactivity as required by the DOJ ITS Standards. The account was then enabled and utilized as a test account without proper authorization.

DOJ ITS Standard – Access Control (AC) Control Family, Version 2.1, AC-02, "*Account Management*", AC-02.05-01 states: "Accounts for recently separated or terminated employees and for recently departed contractors have been locked, disabled, or deleted according to established procedures; including verifying that any organization-required documentation was completed."

AC-02.16-01 also states: “Inactive accounts are automatically locked, disabled, or deleted after 90 days.”

Weak controls for removing and monitoring inactive employee and contractor access to the FPI's information systems increase the risk of unauthorized access and may compromise or adversely affect the integrity and security of financially significant systems and data.

We recommend that the FPI:

4. Revise the documented procedures for the account management process and establish clear roles and responsibilities related to account management. The revised procedures should include requesting, establishing, and re-certification and disablement of user access. *(New)*

Management Response:

FPI concurs with this recommendation.

5. Distribute the revised procedures authorized and approved by stakeholders to the appropriate responsible parties. *(New)*

Management Response:

FPI concurs with this recommendation.

Segregation of Duties Need Improvement for SAP

Weaknesses in documenting segregation of duties within SAP

FPI’s Financial Management Branch (FMB), ERP, and MISB groups did not have documented evidence of maintaining and tracking separation of duties rules within the SAP system since fiscal year 2006.

Department of Justice, Bureau of Prisons System Security Plan for Millennium; dated 3/21/2008, AC-05 “*Separation of Duties*” states: “No user has access authorizations or privileges that may allow the user to perform multiple security functions for which the duties should be performed by separate people.”

DOJ ITS Standard – Access Control (AC) Control Family, Version 2.1, March 2007, AC-05 “*Separation of Duties*”, AC-05.01-01 states: “The information system enforces separation of duties.”

OMB Circular A-130, Appendix III, Security of Federal Information Resources, states: “Application security plans shall include: Personnel Security. Incorporate controls such as separation of duties, least privilege and individual accountability into the application and application rules as appropriate.”

The lack of documentation of separation of duties controls between functional areas elevates the potential for unauthorized change and access to sensitive financial data.

We recommend that the FPI:

6. Revise and maintain documentation addressing segregation of duties and the associated mitigating controls. *(New)*

Management Response:

FPI concurs with this recommendation.

7. Implement an automated account management solution to enforce segregation of duties rules and alert management of any conflicts that arise. *(New)*

Management Response:

FPI concurs with this recommendation.

System Software Needs Improvement

Default configuration settings within the FPI's general and application environment

As previously reported in FY 2007, FPI management has not fully implemented policies and procedures and taken the appropriate actions to detect and prevent installation of systems with default configurations. The default installations of HP Compaq Web Management console on the FPI general support system and the SAP system were identified. These systems had the default password 'administrator' installed. Hot Standby Router Protocol (HSRP) on Cisco routers had authentication data that did not meet the DOJ ITS Standards complexity rules.

In addition, the FPI has data traversing across the network un-encrypted.

DOJ ITS Standard – Configuration Management (CM) Control Family, Version 1.0, December 2006, CM, "*Least Functionality*", CM-07.01-01 states: "Prohibited or restricted functions, ports, protocols, and/or service are disabled or deactivated."

DOJ ITS Standard – Identification and Authentication (IA) Control Family, Version 2.0, December 2006, IA, "*Authenticator Management*", IA-05.02-52, states: "The password policies require that the passwords be composed of representatives of at least three of the following character sets: upper case characters, lower case letters, numeric characters, and special characters (for example: ~ ! @ # $ % ^ & * () _ + = - ' [ ] / ? > <)."

By not changing the default passwords and configurations of software, there is an increased risk of unauthorized users accessing the configurations files; compromising the financial data; bypassing access controls without detection; and potentially affecting the availability, integrity, and confidentiality of the information passing through the network.

We recommend that the FPI:

8. Ensure that default configuration settings and default passwords are removed prior to new services being introduced into the IS environment. *(Updated)*

Management Response:

FPI concurs with this recommendation.

9. Continue to scan the IS environment for default configuration settings and default passwords, make the appropriate changes, and update the applicable baseline configurations and documentation. *(Updated)*

Management Response:

FPI concurs with this recommendation.

10. Use a Secure Sockets Layer (SSL) wrapper to encrypt unsecured protocol (FTP, etc.) transmissions. *(Repeat)*

Management Response:

FPI concurs with this recommendation.

EXHIBIT II

STATUS OF PRIOR YEARS' FINDINGS AND RECOMMENDATIONS

As required by *Government Auditing Standards* issued by the Comptroller General of the United States, and by OMB Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, we have reviewed the status of prior years' findings and recommendations. The following table provides our assessment of the progress FPI has made in correcting the significant deficiency identified during this audit. We also provide the Office of the Inspector General report number where the deficiency remains open, the fiscal year it was identified, our recommendation for improvement, and the status of the condition as of the end of fiscal year 2008:

Report	Significant Deficiency	Recommendation	Status
Annual Financial Statement Fiscal Year 2007 Report No. 08-10	Improvements are Needed in FPI's Financial Management Systems' General Controls.	**Recommendation No. 1**: Monitor all separated user's IS accounts to ensure they are locked, disabled, or deleted from the system in accordance with FPI policy.	Completed
		Recommendation No. 2: Develop, implement, and monitor procedures for tracking inactive accounts.	Completed
		Recommendation No. 3: Implement policies and procedures to review the SAP Millennium and General Support System (Active Directory) security audit logs, including the documentation and review of FPI network administrator's account management activities.	Completed
		Recommendation No. 4: Perform "Infrastructure" and ERP System changes in accordance with FPI and DOJ policies, including the appropriate approvals and documented testing evidence.	Completed
		Recommendation No. 5: Implement policies and procedures to periodically scan the IS environment for default configurations and default passwords, make the appropriate changes, and update the applicable baseline configurations and documentation.	In Process (Updated by FY 2008 Recommendations No. 8 and 9)
		Recommendation No. 6: Use a Secure Sockets Layer (SSL) wrapper to encrypt unsecured protocol (FTP, etc.) transmissions.	In Process (FY 2008 Recommendation No. 10)

Federal Prison Industries, Inc.

Balance Sheets

As of September 30, *(DOLLARS IN THOUSANDS)*	2008	2007
Assets		
Current:		
Cash and cash equivalents	$ 372,691	$ 417,090
Accounts receivable, net	44,869	68,261
Inventories, net	250,116	181,223
Other assets	8,587	2,016
Total current assets	676,263	668,590
Property, plant and equipment, net	131,651	129,730
Total Assets	$ 807,914	$ 798,320
Liabilities and United States Government Equity		
Current:		
Accounts payable	$ 68,068	$ 70,450
Deferred revenue	208,911	186,781
Accrued salaries and wages	11,506	10,412
Accrued annual leave	10,291	9,805
Note payable to United States Treasury	-	20,000
Other accrued expenses	13,097	9,495
Total current liabilities	311,873	306,943
FECA actuarial liability	12,010	10,465
Total Liabilities	323,883	317,408
United States Government Equity		
Initial capital	4,176	4,176
Cumulative results of operations	479,855	476,736
Total United States Government Equity	484,031	480,912
Total Liabilities and United States Government Equity	$ 807,914	$ 798,320

The accompanying notes are an integral part of these financial statements.

Federal Prison Industries, Inc.

Statements of Operations and Cumulative Results of Operations

For the fiscal years ended September 30, (DOLLARS IN THOUSANDS)	2008	2007
Revenue:		
Net sales	$ 854,279	$ 852,724
Other revenue	111,670	105,054
Total revenue	965,949	957,778
Cost of revenue:		
Cost of sales	786,131	748,615
Cost of other revenue	115,934	109,290
Total Cost of Revenue	902,065	857,905
Gross profit	63,884	99,873
Operating expenses:		
Sales and marketing	4,650	4,920
General and administrative	108,288	103,710
Total operating expenses	112,938	108,630
Loss from operations	(49,054)	(8,757)
Interest income	11,144	17,849
Interest expense	(15)	(24)
Other income, net	41,044	36,721
Net income	3,119	45,789
Cumulative results of operations, beginning of fiscal year	476,736	430,947
Cumulative results of operations, end of fiscal year	$ 479,855	$ 476,736

The accompanying notes are an integral part of these financial statements.

Federal Prison Industries, Inc.

Statements of Cash Flows

For the fiscal years ended September 30, (DOLLARS IN THOUSANDS)	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 3,119	$ 45,789
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	9,775	9,382
Loss on disposal of property, plant and equipment	134	128
Changes in:		
Accounts receivable	23,392	(24,222)
Inventories	(68,893)	6,865
Other assets	(6,571)	(841)
Accounts payable and accrued expenses	4,345	15,739
Deferred revenue	22,130	6,016
Net cash provided by operating activities	(12,569)	58,856
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of property, plant and equipment	(9,685)	(11,632)
Construction-in-progress of plant facilities	(2,145)	(8,507)
Net cash used in investing activities	(11,830)	(20,139)
CASH FLOWS FROM FINANCING ACTIVITIES		
Principal Payment of Note Payable	(20,000)	-
Net cash used in financing activities	(20,000)	-
Net (decrease) increase in cash and cash equivalents	(44,399)	38,717
Cash and cash equivalents, beginning of fiscal year	417,090	378,373
Cash and cash equivalents, end of fiscal year	$ 372,691	$ 417,090

The accompanying notes are an integral part of these financial statements.

Note 1. Organization and Mission

Federal Prison Industries, Inc. (FPI) was established in 1934 by an act of the United States Congress. FPI operates under the trade name UNICOR, as a wholly-owned federal government corporation within the Department of Justice, and functions under the direction and control of a Board of Directors, (the "Board"). Members of the Board are appointed by the President of the United States of America and represent retailers and consumers, agriculture, industry, labor, the Attorney General, and the Secretary of Defense. FPI's statutory mandate is to provide employment and training for inmates in the Federal Prison System while remaining self-sufficient through the sale of its products and services.

FPI's federal government customers include departments (percent of Revenue shown in parenthesis), agencies and bureaus such as the Department of Defense (54%), the Department of Homeland Security (22%), the Department of Justice (7%), the General Services Administration (3%), and the Social Security Administration (2%). These and other federal organizations are required to purchase products from FPI, if its products meet the customer's price, quality, and delivery standards, under a mandatory source preference specified in FPI's enabling statute and the Federal Acquisition Regulation.

FPI has industrial operations at 109 and 110 factories located at 76 and 79 prison facilities that employed 21,836 and 23,152 inmates representing approximately 17% and 16% of the total number of inmates housed in BOP facilities as of September 30, 2008 and September 30, 2007, respectively.

Note 2. Summary of Significant Accounting Policies

Basis of Accounting

FPI transactions are recorded on the accrual basis of accounting. Under the accrual basis, revenues are recorded when earned and expenses are recorded when incurred, regardless of when the cash is exchanged.

Basis of Presentation

FPI has historically prepared its external financial statements in conformity with U.S. generally accepted accounting principles based on accounting standards issued by the Financial Accounting Standards Board (FASB), the private sector standards-setting body. The Federal Accounting Standards Advisory Board (FASAB) has been designated as the standards-setting body for federal financial reporting entities with respect to the establishment of US GAAP. FASAB allows certain government agencies, which FPI management believes would include FPI, to utilize FASB standards for Financial Statement presentations.

Use of Estimates

The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

Cash and Cash Equivalents

FPI considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents. FPI limits its investment activities and cash equivalents to short-term overnight repurchase agreements with the Bureau of Public Debt of the United States Treasury. The market value of these overnight repurchase agreements is equivalent to cost.

Accounts Receivable / Concentration of Credit Risk

Financial instruments that potentially subject FPI to concentrations of credit risk consist primarily of accounts receivable. FPI sells products and services to various federal government departments, agencies and bureaus, as well as certain private sector companies, without requiring collateral. Accounts receivable consists of amounts due from those entities and is stated net of an allowance for doubtful accounts.

FPI routinely assesses the payment histories of its federal customers and the financial strength of its private sector customers and maintains allowances for anticipated losses as they become evident. In this regard, a significant amount of accounts receivable remained past due at September 30, 2008 and September 30, 2007. A majority of these past due items relate to billings to various entities within Department of Defense (DOD) who rely on the Defense Finance and Accounting Service (DFAS) to process vendor payments. Historically, customer payments processed through DFAS have generally taken longer to receive than payments from other federal and private sector customers. FPI believes that ultimately, a majority of its past-due accounts receivable are fully collectable. The amount due FPI, net of allowances, from DOD for the fiscal years ended September 30, 2008 and 2007 was $31,148 and $46,850 respectively.

While federal accounts receivable are normally fully collectible in accordance with federal law, FPI has established an allowance for future losses against its federal accounts receivable to account for potential billing errors related to pricing and customer discounts, as well as instances of expired or cancelled funding from its federally appropriated customers. At September 30, 2008 and 2007, FPI's allowance for doubtful accounts is stated at approximately $990 and $1,293, respectively, of which approximately $891 and $1,164, respectively, represents the amounts allocated against federal accounts receivable.

Inventories

FPI maintains its inventory primarily for the manufacture of goods for sale to its customers. FPI's inventory is composed of three categories: Raw Materials, Work in Process, and Finished Goods. These categories are generally defined by FPI as follows: Raw Materials consist of materials that have been acquired and are available for the production cycle, Work in Process is composed of materials that have moved into the production process and have some measurable amount of labor and overhead added by FPI, Finished Goods are materials with FPI added labor and overhead that have completed the production cycle and are awaiting sale to customers.

Raw material inventory value is based upon moving average cost. Inventories are valued at the lower of average cost or market value (LCM) and include materials, labor and manufacturing overhead. Market value is calculated on the basis of the contractual or anticipated selling price, less allowance for administrative expenses. FPI values its finished goods and sub-assembly items at a standard cost that is periodically adjusted to approximate actual cost. FPI has established inventory allowances to account for LCM adjustments and excess and/or obsolete items that may not be utilized in future periods. This valuation method approximates historical cost.

Advances to Vendors

FPI generally does not offer advances to the public, however, where warranted, FPI will on occasion make an advance to a vendor upon their request. Historically, these advances have been insignificant and made primarily to the Industries for the Blind. During 2008, FPI established a pilot program to produce solar panels in anticipation of an expanding the federal market as a result of Executive Order 13423 "Strengthening Federal Environmental, Energy, and Transportation Management." which requires federal agencies to improve energy efficiencies by the year 2015. Customarily, suppliers of the raw materials to produce solar panels require advances to procure their own materials. Prior to issuing any advances to a vendor, the Centralized Accounts Receivable section performs a review as though they were a public customer, to include performing a due diligence review to assess risk and a review of applicant financial statements. A letter of credit is obtained as needed based on the results of this review. The FPI Controller approves advances prior to their disbursement. Advances are reduced by offset to the vendor invoice as goods are delivered.

Revenue Recognition

FPI sells a wide range of products and services to a diversified base of customers, primarily governmental departments, agencies and bureaus. Revenue is generally recognized when delivery has occurred or services have been rendered, persuasive evidence of an arrangement exists, there is a fixed or determinable price, and collectibility is reasonably assured. Revenue from contracts that require customer acceptance are not recognized until either customer acceptance is obtained, or upon completion of the contract. Provisions for anticipated contract losses and sales returns are recognized at the time that they become evident.

Revenue is recognized on multiple element agreements as a single unit of accounting for manufactured items when the product has been accepted by the customer. Revenue for services provided on behalf of FPI is recognized when the service provider presents a valid invoice including a customer acceptance or completion notice.

FPI records as other revenue the shipping and handling costs that have been billed to our customers. The cost of providing this service is recorded as a cost of other revenue.

Deferred revenue is comprised of customer cash advances, which have been paid to FPI prior to the manufacturing of goods, delivery of goods, or performance of services.

Other income is comprised primarily of imputed financing for retirement, health benefits and life insurance (Note 9).

Property, Plant and Equipment

Property, plant and equipment are stated at cost, net of accumulated depreciation. Depreciation is computed using the straight-line method over the following estimated useful lives:

	Years
Machinery & Equipment	5 - 25
Computer Hardware	5 - 10
Computer Software	3 - 5
Building & Improvements	24- 40

Upon retirement or disposition of property and equipment, the related gain or loss is reflected in the statements of operations. Repairs and maintenance costs are expensed as incurred.

Taxes

As a wholly-owned corporation of the federal government, FPI is exempt from federal and state income taxes, gross receipts tax, and property taxes.

(DOLLARS IN THOUSANDS)

Note 3. Accounts Receivable, Net

Accounts receivable, net consists of the following:

As of September 30,	**2008**	**2007**
Intragovernmental billed receivables	$ 37,388	$ 56,194
Private sector billed receivables	8,471	13,360
	45,859	69,554
Less allowance for doubtful accounts	990	1,293
Accounts receivable, net	$ 44,869	$ 68,261

FPI incurred bad debt expense of $1,097 and $(87), respectively, for the fiscal years ended September 30, 2008 and 2007.

Note 4. Inventories, Net

Inventories, net consist of the following:

As of September 30,	**2008**	**2007**
Raw materials	$ 51,631	$ 44,071
Raw materials – vehicles	96,656	42,577
Work-in-process	44,318	43,598
Finished sub-assemblies	12,351	9,463
Finished goods	37,883	34,692
Finished goods – acceptance contracts	21,777	18,764
	264,616	193,165
Less inventory allowance	14,500	11,942
Inventories, net	$ 250,116	$ 181,223

$96,656 of FPI's fiscal year 2008 and $42,577 of FPI's fiscal year 2007, raw materials balance represents vehicles and component parts for use in the Fleet Management and Vehicular Components (FMVC) business group's retrofit product line. A majority of that inventory balance has been contracted on behalf of the Customs and Border Protection and Bureau of Immigration and Customs Enforcement of the Department of Homeland Security (DHS) for retrofit services that are performed by FPI. As part of an interagency agreement, DHS provides advance funding to FPI to procure these vehicles. Revenue is recognized by FPI at the time of shipment of retrofitted vehicles to DHS.

(DOLLARS IN THOUSANDS)

$21,777 of FPI's fiscal year 2008 and $18,764 of FPI's fiscal year 2007 finished goods balance represents goods that have been shipped to customers or their agents, but for which revenue has not been recognized because of acceptance criteria within the customer contract. The balances as of September 30, 2008 and September 30, 2007 are primarily systems furniture installations and destination acceptance contracts shipped after the cutoff for revenue recognition.

Note 5. Property, Plant and Equipment, Net

Property, plant and equipment, net consist of the following:

As of September 30,	**2008**	**2007**
Buildings and improvements	$ 187,431	$ 172,462
Machinery and equipment	112,374	112,525
Computer hardware	1,660	4,161
Computer software	5,778	8,595
	307,243	297,743
Less accumulated depreciation	181,328	184,612
	125,915	113,131
Factory construction-in-progress	5,736	16,599
Property, plant and equipment, net	$ 131,651	$ 129,730

Depreciation and amortization expense approximated $9,775 and $9,382 for the fiscal years ended September 30, 2008 and 2007, respectively.

As of September 30, 2008, various projects were in progress for the construction of new industrial facilities and the renovation of existing facilities. In addition, during the next fiscal year, FPI is planning to invest approximately $20,245 for the purchase and construction of property, plant, and equipment.

(DOLLARS IN THOUSANDS)

Note 6. Other Accrued Expenses

Other accrued expenses consist of the following:

As of September 30,	2008	2007
Materials in transit	$ 642	$ 102
Relocation Travel Expense	2,713	1,785
FECA liabilities – current portion	1,489	1,221
Financial audit expense	307	440
Telecommunication Expense	473	808
Utilities	1,026	373
Warranty expense	471	453
Gain sharing expense	-	450
Other expense	5,976	3,863
Other accrued expenses	$ 13,097	$ 9,495

Included in other expense as of September 30, 2008 and September 30, 2007 are accruals for Intra-Departmental agreements of $2,399 and $995 and accruals for vendor invoices of $1,201 and $2,009, respectively.

Note 7. Note Payable to United States Treasury

Congress has granted FPI borrowing authority pursuant to Public Law 100-690. Under this authority, FPI borrowed $20,000 from the Bureau of Public Debt of the United States Treasury (the Treasury) with an extended lump-sum maturity date of September 30, 2008. FPI repaid this note to the Treasury on September 30, 2008. The funds received under this note were internally restricted for use in the construction of plant facilities and the purchase of equipment. Terms of the note included accrued interest, payable March 31 and September 30 of each fiscal year at 5.5% (the rate equivalent to the yield of United States Treasury obligations of comparable maturities which existed on the date of a note maturity extension, granted in fiscal year 1998). According to the terms, accrued interest payable under the note were either fully or partially offset to the extent FPI maintained non-interest bearing cash deposits with the Treasury. In this regard, there was no accrual of interest unless FPI's daily cash balance on deposit with the Treasury was less than the unpaid principal balance of all note advances received, as determined by a monthly calculation performed by the Treasury. When FPI's daily cash balance was less than the unpaid principal balance of all note advances received, interest was calculated by the Treasury on the difference between these two amounts. The note agreement provided for certain restrictive covenants and a prepayment penalty for debt retirements prior to 2008. Additionally, the agreement limited authorized borrowing in an aggregate amount not to exceed 25% of FPI's net worth.

(DOLLARS IN THOUSANDS)

There was no interest expense for the fiscal years ended September 30, 2008 and September 30, 2007.

Note 8. Business Segments

FPI's businesses are organized, managed and internally reported as seven operating segments based on products and services. These segments are Clothing and Textiles; Electronics; Fleet Management and Vehicular Components; Industrial Products; Office Furniture; Recycling; and Services. These segments represent virtually all of FPI's product lines. FPI is not dependent on any single product as a primary revenue source; however, it is dependent on the federal government market for the sale of its products and services. FPI's net sales for the fiscal years ended September 30, 2008 and 2007 for each of its business segments is presented for comparative purposes:

Net Sales ***For the years ended September 30,***	**2008**	**2007**
Business Segment		
Clothing and Textiles	$ 203,644	$ 175,271
Electronics	218,848	326,329
Fleet Management and Vehicular Components	229,168	156,364
Industrial Products	26,921	32,804
Office Furniture	129,572	115,993
Recycling	10,505	11,183
Services	35,621	34,780
Net sales	$ 854,279	$ 852,724

Regulatory Compliance

FPI's ability to add or to expand production of a specified product is regulated by the Federal Prison Industries Reform Act ("the Act"). The Act provides specific guidelines to FPI regarding its methodology for evaluating and reporting new or expanded products, including requiring FPI to provide direct notice to trade associations and interested parties of such actions. Finally, publication of annual decisions of the FPI Board of Directors and semi-annual sales disclosures are mandated under the Act.

Note 9. Intra-Department of Justice (DOJ) / Intragovernmental Financial Activities

FPI's financial activities interact with and are dependent upon those of DOJ and the federal government as a whole. The following is a discussion of certain intra-DOJ and intragovernmental activities and their relationship with FPI:

Relationship with the Federal Bureau of Prisons

FPI and the Federal Bureau of Prisons (BOP) have a unique relationship in that the nature of their respective missions requires the sharing of facilities and responsibilities relative to the custody, training and employment of federal inmates. The Director of the BOP serves as the Chief Executive Officer of FPI and the Chief Operating Officer of FPI serves as an Assistant Director of the BOP. The BOP provides land to FPI for the construction of its manufacturing facilities and both FPI and BOP share certain facilities, generally at no cost to FPI. In accordance with Managerial Cost Accounting Concepts a reasonable estimate of these costs as provided by the BOP is included in general expense and other income of FPI for the fiscal years ended September 30, 2008 and 2007, respectively.

Self Insurance

In accordance with federal government policy, FPI is uninsured with respect to property damage, product liability, and other customary business loss exposures. Losses incurred are absorbed as a current operating expense of FPI or, if they are induced by factors related to FPI's relationship with the Federal Prison System, may be reimbursed by BOP. Certain other costs, principally relating to personal injury claims, are paid directly by the federal government.

Federal Employees Compensation Act

The Federal Employees Compensation Act (FECA) provides income and medical cost protection to cover federal civilian employees injured on the job, employees who have incurred a work-related occupational disease, and beneficiaries of employees whose death is attributable to a job related injury or occupational disease. The United States Department of Labor (DOL), which administers FECA, annually charges each federal agency and department for its applicable portion of claims and benefits paid in the preceding year. As of September 30, 2008 and September 30, 2007, the accrued FECA liabilities as charged to FPI, approximated $1,489 and $1,221, respectively.

DOL also calculates the liability of the federal government for future claims and benefits, which includes the estimated liability of death, disability, medical, and other approved costs. Future claims and benefits are determined from an actuarial extrapolation, utilizing historical benefit payment patterns and calculations of projected future benefit payments discounted to current value over a 23.5 year period. FPI's estimated future liability approximated $12,010 and $10,465 at September 30, 2008 and 2007, respectively.

Retirement

Substantially all of FPI's civilian employees are covered under either the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS). For employees covered under CSRS (those employees hired prior to January 1, 1984), FPI contributed approximately 7.0 percent (for normal retirement) or 7.5 percent (for hazardous duty retirement) of each employee's salary. CSRS covered employees do not have Federal Insurance Contributions Act (FICA) withholdings and, thus, are not fully eligible to receive Social Security benefits. For employees covered by the FERS, (generally those employees hired on or after January 1, 1984), FPI contributed (for normal retirement) 11.2 percent for fiscal years ended September 30, 2008 and September 30, 2007. FPI contributed (for hazardous retirement) 24.9 percent for fiscal year ended September 30, 2008 and 23.8 percent for fiscal year ended September 30, 2007.

Under FERS, employees also receive retirement benefits from Social Security and, if applicable, benefits from a defined contribution plan (thrift). Under the thrift plan, an employee may contribute (tax deferred) up to $15,500 of salary to an investment fund. FPI then matches this amount up to 4 percent, in addition to an automatic 1 percent that is contributed for all FERS employees. Those employees, which elected to remain under CSRS after January 1, 1984, continue to receive benefits in place, and may also contribute (tax deferred) up to 10 percent of their salary to the thrift plan, but with no matching amount contributed by FPI.

CSRS and FERS are multi-employer plans. Although FPI funds a portion of pension benefits relating to its employees, and provides for the necessary payroll withholdings, it does not maintain or report information with respect to the assets of the plans, nor does it report actuarial data with respect to accumulated plan benefits or the pension liability relative to its employees. The reporting of such amounts is the responsibility of the United States Office of Personnel Management (OPM).

FPI's contribution to both plans approximated $31,585 and $29,062 for the fiscal years ended September 30, 2008 and 2007, respectively.

FPI must recognize its share of the cost of providing pension benefits to eligible employees utilizing cost factors determined by the OPM. Included in general and administrative expense is approximately $1,274 and $1,528 in the fiscal years ended September 30, 2008 and 2007, respectively, with an offsetting credit to imputed financing sources.

Health Benefits and Life Insurance

FPI, through the OPM, offers health and life insurance plans under which premium costs for health care are shared between FPI and the employees. A substantial portion of life insurance premiums are paid for by employees. Amounts paid by FPI for health benefits and life insurance approximated $10,253 and $9,926 for the fiscal years ended September 30, 2008 and 2007, respectively.

OPM also provides health care and life insurance benefits for FPI's retired employees. FPI must recognize an expense related to its share of the cost of such post-retirement health benefits and life insurance on a current basis (while its employees are still working), with an offsetting credit to other income. Costs in this regard, which approximated $7,628 and $7,992 during the fiscal years ended September 30, 2008 and 2007, respectively, were determined by OPM utilizing cost factors used to estimate the cost of providing post-retirement benefits to current employees. However, because of the offsetting credit, the recording of these costs has no impact on reported net income or cash flows.

Future post-retirement health care and life insurance benefit costs are not reflected as a liability on FPI's financial statements, as such costs are expected to be funded in future periods by OPM.

(DOLLARS IN THOUSANDS)

Note 10. Sales and Marketing, General and Administrative Expenses

Sales and marketing, general and administrative expenses consist of the following:

Sales and marketing, general and administrative expenses ***Fiscal years ended September 30,***	**2008**	**2007**
Salaries, wages and benefits	$ 43,278	$ 41,940
Permanent change of station expense	3,745	1,969
Purchases of minor equipment	1,224	1,894
Contract services	11,045	9,565
Bad debt expense	1,097	(87)
Credit card services	-	1,005
Travel	2,893	2,502
Customer Incentives Expense	3,516	6,402
Personal Computer Expense	736	2,073
Depreciation	1,651	1,260
Gain on Disposition of Assets	(8)	(75)
Loss on Disposition of Assets	134	128
Other Expense	7,162	5,526
Imputed pension costs (Note 9)	1,274	1,528
Imputed post-retirement health care and life insurance cost (Note 9)	7,628	7,992
Imputed Operating Costs	27,563	25,008
Sales and marketing, general and administrative expenses	$ 112,938	$ 108,630

Other expense is comprised primarily of inmate wages, maintenance agreements, civilian accident compensation (FECA), financial audit expenses, and certain sales and marketing expenses. Contract services consist primarily of consulting and sales and marketing fees. Salaries, wages and benefits are shown net of the imputed financing offsetting credit (Note 9).

Note 11. Commitments and Contingencies

Legal Contingencies

FPI is involved in various legal actions, including administrative proceedings, lawsuits, and claims. In the opinion of the organization's legal counsel and management, these suits are without substantial merit and should not result in judgments, which in the aggregate would have a material adverse effect on the organization's financial statements.

(DOLLARS IN THOUSANDS)

Lease Commitments

FPI leases certain facilities, machinery, vehicles and office equipment under noncancelable capital and operating lease agreements that expire over future periods. Many of these lease agreements provide FPI with the option (after initial lease term) to either purchase the leased item at the then fair value or to renew the lease for additional periods of time. As of September 30, 2008, future capital lease payments due and future operating lease commitments total $216 and $89, respectively.

Product Warranty

FPI offers its customers a promise of an "Escape Proof Guarantee" on the products it manufactures. FPI Management has analyzed the historical pattern of warranty returns and the adequacy of the warranty returns and allowances. In this regard, Management has established an estimate of future warranty returns related to current period product revenue.

Changes in aggregate product warranty liability Fiscal years ended September 30,	**2008**	**2007**
Balance at the beginning of the period	$ 453	$ 427
Accruals for warranties issued during the period	375	282
Settlements made (in cash or in kind) during the period	(357)	(256)
Balance at the end of the period	$ 471	$ 453

Minimum Buy Agreements

FPI is obligated under certain "Minimum Buy" purchase agreements to procure a specified minimum quantity of raw materials. These agreements are generally related to the Clothing and Textiles and Electronics business groups.

Congressional Limitation on Administrative Expenses

Congress has imposed an annual spending limit on certain administrative expenses relating to FPI's central office management. These costs include salaries for management personnel, travel expenses and supplies. The following is a comparison of actual expenses to the limitation imposed:

Congressional limitation on administrative expenses

Fiscal years ended September 30,	**2008**	**2007**
Congressional limitation on expenses	$ 2,328	$ 2,477
Expenses incurred subject to Congressional limitation	$ 2,089	$ 2,241